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Chairman
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Small Business Tax Fairness Act

H.R. 3081

Committee on Ways & Means
No Report Filed
Introduced by Mr. Lazio *et al.* on October 14, 1999

Floor Situation:

The House is scheduled to consider H.R. 3081 on Thursday, March 9, 2000. The Rules Committee is scheduled to meet on the bill at 2:30 p.m. on Wednesday, March 8. Additional information on the rule and potential amendments will be provided in a *FloorPrep* prior to floor consideration.

Highlights:

Please Note: The following analysis is based on the text of H.R. 3832, which was introduced by Mr. Archer on March 6; the Rules Committee is expected to make in order the text of H.R. 3832 as a substitute for H.R. 3081.

H.R. 3081 provides approximately $45.3 billion in tax relief over five years from FY 2001-2005. In addition, the measure includes $463 million in FY 2000 tax relief by reinstating the installment method of accounting, for a total of $45.8 billion in tax relief over six years. Specifically, the bill:

* reduces estate and gift taxes over a five-year period, providing $26.9 billion in tax relief;

* includes measures designed to reform pensions and enhance retirement security (providing $6.1 billion in tax relief over five years). Specifically, the bill (1) increases pension portability so employees may "roll over" plans from one job to the next; (2) provides additional salary "catch-up" contributions for workers over age 50 (*i.e.*, these individuals may deposit additional amounts into certain retirement accounts); (3) accelerates vesting requirements for employer matching contributions; (4) increases contribution and benefit limits in defined contribution and benefit plans; and (5) simplifies the pension system to help small businesses offer and large businesses improve their pension plans;

* increases the deduction for health insurance of self-employed individuals to 100 percent beginning in 2001, providing $2.1 billion in tax relief over five years;

* authorizes the HUD Secretary to designate 15 “renewal communities” in both urban and rural areas, allowing them to qualify for special tax incentives, reducing taxes by $922 million over five years;

* increases the deductible percentage of business meal expenses to 60 percent in 2002 (from the current level of 50 percent), providing $4.5 billion in tax relief over five years;

* includes a number of provisions to provide real estate tax relief, reducing taxes by $922 million over five years; and

* repeals a provision enacted last year that requires small business owners who sell their businesses to immediately pay all capital gains taxes resulting from the sale in one lump sum, even if the sale’s payments are spread out in installments over several years (this repeal provides $1.8 billion in tax relief over six years, including $463 million in FY 2000).

Background:

In 1996, when Congress last raised the minimum wage, lawmakers pursued a two-track strategy by considering legislation to increase the minimum wage and provide small business tax relief. The House adopted a single rule that merged the bills into one measure after they had been passed separately.

Congress included limited tax relief (approximately $20 billion over 10 years) in the 1996 law (*P.L. 104-188*) to offset the $1 increase in the minimum wage. Specifically, the law (1) increased expensing for small businesses; (2) modified the rules regarding Subchapter S corporations to make it easier for small businesses to expand; (3) established a new simplified pension plan for small businesses with fewer than 100 employees; (4) extended a number of expiring tax credits; and (5) established charitable risk pools to allow organizations to pool insurance costs for their members in order to reduce premium costs. Finally, the measure established a $5,000 tax credit to encourage a greater number of adoptions.

Last August, Congress passed the 1999 Taxpayer Refund & Relief Act (H.R. 2488; *H.Rept. 106-289*) to provide approximately $792 billion in broad-based tax relief over 10 years, including a number of measures outlined in this summary. However, President Clinton vetoed the measure. Later in 1999, House leaders debated whether to set a floor vote for H.R. 3081 (which was reported from the Ways & Means Committee by a vote of 23-14 on November 9, 1999) that included a $1 increase in the minimum wage *and* small business tax relief. However, it remained unclear whether there was sufficient votes to pass the measure, so House leaders are now pursuing a different, two-track strategy similar to the process used in 1996.

Provisions:

— Estate and Gift Tax Relief —

H.R. 3081 includes a number of measures to provide approximately $26.9 billion in estate and gift tax relief over five years. These changes are outlined below.

Estimated Tax Relief By Section

Bill Section	FY 2000 Tax Relief*	FY 2001 Tax Relief	FY 2000-2005 Tax Relief
		(in millions)	
Small Business Tax Relief	$463.0	$1,666.0	$10,721.0
Pension Reforms	—	$548.0	$6,144.0
Estate & Gift Tax Relief	—	$16.0	$26,943.0
Distressed Communities & Industries	—	$107.0	$1,020.0
Real Estate Provisions	—	$16.0	$922.0
NET TOTALS	$463.0	$2,353.0	$45,750.0

Source: Joint Committee on Taxation

* All $463 million in FY 2000 tax relief is provided by reinstating the installment method of accounting

Estate, Gift, and GST Taxes. The measure reduces the estate, gift, and generation-skipping transfer (GST) taxes over five years. Beginning in 2001, the bill replaces the unified credit with a unified exemption and repeals the five-percent surtax and rates in excess of 53 percent. Beginning in 2002, the bill repeals rates in excess of 50 percent. In 2003 and 2004, the bill reduces all estate and gift tax rates by one percentage point, and outlines a proportionate reduction in the state death tax credit. Finally, the bill makes a number of modifications to the GST tax to simplify current law. These changes are similar to the provisions in H.R. 2488 (however, the taxes are reduced over five years, as opposed to a phased-in repeal over 10 years in the Taxpayer Refund and Relief Act). Finally, the measure expresses the sense of Congress that these provisions represent a first step in an effort to ultimately repeal the estate, gift, and generation skipping taxes.

The federal estate and gift taxes are a unified tax system: a transfer of wealth, whether made during the life of the donor or at death, is taxed under the same general structure. The unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 55 percent on such transfers over $3 million. In addition, the government imposes a five-percent surtax on cumulative taxable transfers between $10 million and the amount necessary to phase out the benefits of the graduated rates. Under the 1997 Taxpayer Relief Act (*P.L. 105-34*), the unified credit exempted $650,000 in 1999, which increases to $675,000 in 2000 and 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million in 2006 and thereafter.

The GST tax is designed to prevent an individual from transferring property to successive generations without being subject to the estate and gift tax for each generation. Current law provides a $1 million exemption (indexed to inflation beginning in 1999) for each individual making generation-skipping transfers.

Conservation Easements. H.R. 3081 expands the availability of qualified conservation easements by modifying certain distance requirements. Specifically, the bill increases the distance from which the land must be situated from a metropolitan area, national park, or wilderness area from 25 to 50 miles, and from an Urban National Forest from 10 to 25 miles. It also clarifies that the date for determining easement compliance is the date on which the donation is made. Under current law, an executor may exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter.

— *Small Business Tax Relief* —

H.R. 3081 provides approximately $10.7 billion in small business tax relief over five years. These changes are outlined below.

Self-Employed Health Insurance Deduction. H.R. 3081 increases the deduction for health insurance (as well as qualified long-term expenses) of self-employed individuals to 100 percent beginning in 2001. This provision modifies current law, which does not phase in full deductibility of health insurance expenses for self-employed individuals until 2003. Under current law, individuals may deduct 60 percent of their health insurance expenses in 1999 through 2001, 70 percent in 2002, and 100 percent in 2003.

Increase in Section 179 Expensing. The bill increases the small business equipment expense deduction to $30,000 annually beginning in 2001. Current law phases in a $25,000 deduction limit over five years, reaching this level in 2003; small business taxpayers currently may deduct $20,000.

Business Meal Deduction. The measure increases the business meal expenses deduction to 55 percent in 2001 (from the current level of 50 percent) and to 60 percent in 2002. The bill also accelerates the phase-in for the business meal deduction for individuals subject to Transportation Department hours-of-service limitations. Under current law, the deduction is scheduled to increase from 55 percent in 1999 to 80 percent in 2008. The bill increases the deduction to 80 percent beginning in 2001.

Farmer and Fisherman Income Averaging. H.R. 3081 extends farmer income averaging to commercial fishermen and coordinates the averaging rules with the alternative minimum tax, effective in 2001.

Occupational Taxes. The bill repeals occupational taxes on distilled spirits, wine, and beer for retailers, wholesalers, and producers, effective July 1, 2001. Under current law, the producers and marketers of these alcoholic beverages must pay an annual tax (between $250 and $1,000 per premise) on July 1 of each year.

Accounting Method Repeal. H.R. 3081 repeals a provision enacted last year as part of the "tax extenders" legislation (*P.L. 106-170*) that prohibits the use of the installment method of accounting when selling property that otherwise must be reported for federal income tax purposes using an accrual method of accounting.

Under the new law, many small business owners who sell their businesses must immediately pay all capital gains taxes resulting from the sale in one lump sum, even if the sale's payments are spread out in installments over a period of several years. Under previous law, the business owner could have spread the capital gains tax payment over the life of the installment note. This bill repeals this law retroactive to its effective date on December 17, 1999 (*i.e.*, as if it were never enacted).

— *Pension Reforms* —

H.R. 3081 outlines measures designed to reform pension systems and enhance retirement security. These provisions provide approximately $6.1 billion in tax relief over five years and are similar to the Taxpayer

Refund and Relief Act (although the bill includes a number of new minor provisions). These provisions are outlined below.

Expansion of Coverage. The measure increases contribution and benefit limits in tax-favored retirement plans. Specifically, the bill (1) increases the $30,000 annual contribution limit for defined contribution plans to $40,000 (indexed in $1,000 increments); (2) increases the $130,000 annual benefit limit under a defined benefit plan to $160,000 (indexed in $5,000 increments); and (3) increases the $160,000 compensation limit to $200,000 (indexed in $5,000 increments). The bill extends the "Roth IRA" concept (*i.e.*, depositing after-tax contributions to receive tax-free distributions) to 401(k) and 403(b) plans (otherwise known as "tax-deferred annuities") whereby participants may elect to have salary deferrals treated as after-tax contributions.

Beginning in 2001, the bill increases the dollar limit on annual elective deferrals under section 401(k) plans, tax-deferred annuities, and salary reduction simplified employee pension plans (SEPs) in $1,000 annual increments until the limits reach $14,000 in 2004. Beginning in 2001, the proposal increases the maximum annual elective deferrals that may be made to a SIMPLE retirement account in $1,000 annual increments until the limit reaches $10,000 in 2004. The proposal increases the dollar limit on deferrals under a section 457 plan (*i.e.*, an eligible deferred compensation plan of a state or local government or tax-exempt employer) to conform to the elective deferral limitation. Thus, the limit will be $11,000 in 2001 and continue to increase in $1,000 annual increments until it reaches $14,000 in 2004. The above limits will be indexed annually thereafter in $500 increments.

In addition, the bill (1) modifies and simplifies "top-heavy rules" (*i.e.*, top-heavy benefit plans may provide additional benefits and are targeted to an employer's key employees); (2) stipulates that elective deferral contributions are not subject to qualified plan deduction limits; (3) repeals coordination requirements for section 457 plans of state and local governments and tax-exempt organizations; and (4) eliminates IRS user fees for determination letter requests by small employers.

Enhancing Fairness for Women. The measure (1) allows additional salary reduction "catch-up" contributions for workers over age 50 (*i.e.*, these individuals may deposit additional amounts into certain retirement accounts); (2) accelerates vesting requirements for employer matching contributions; (3) provides equitable treatment for contributions to defined contribution plans by eliminating "percentage of compensation" limitations; (4) simplifies and updates minimum distribution rules that apply to tax-favored plans; (5) clarifies the tax treatment on the division of section 457 plans upon divorce; and (6) modifies the safe harbor period for hardship withdrawals from 401(k) plans.

Portability. The bill increases portability of retirement assets so employees may roll over such assets from one job to the next. Specifically, the bill allows individuals to roll over eligible distributions from qualified retirement plans, tax-deferred annuities, and section 457 state and local governments plans. In addition, the bill allows an employee to roll over after-tax contributions into another qualified plan in a direct rollover, or to an IRA. Finally, the bill (1) expands espousal rollovers; (2) allows pension plans to eliminate unnecessary distribution options; (3) allows employers to disregard rollovers for purposes of the cash-out rules; (4) allows employees to access benefits from 401(k) plans, tax-deferred annuities, and section 457 plans after "severing employment" rather than "separation from service" (*i.e.*, allows distributions when an employee continues in the same job after a merger); (5) allows a hardship exception to the 60-day rollover rule; and (6) allows the use of tax-deferred annuity and section 457 plan assets to purchase service credit in governmental defined benefit plans.

Pension Security. The measure includes several provisions designed to allow companies to better fund their plans and strengthen disclosure requirements. Specifically, the bill phases in the repeal of the current 150 percent contribution limit to defined benefit plans by 2004. Present law contributions to plans that exceed 150 percent of current liability are not tax-deductible (this limit will phase up to 170 percent by 2003 and be fully phased out in 2004). The bill also provides excise tax relief for sound pension funds and requires plan administrators to notify recipients of significant reductions in future benefits. Finally, the measure stipulates that the 100 percent of compensation limit for defined benefit plans does not apply to multi-employer plans.

Regulatory Burdens. H.R. 3081 includes a number of provisions designed to simplify the pension system to help small businesses offer and large employers improve their pension plans. Specifically, the bill (1) allows an employer to reinvest employee stock ownership plan dividends without losing the dividend deduction; (2) extends the notice and consent period regarding distributions to allow individuals to plan for and request pension distribution further in advance; (3) simplifies annual filing requirements for pension plans with fewer than 25 employees; (4) repeals several complex regulatory tests required of employers; (5) clarifies the tax treatment of employer-provided retirement planning services; and (6) modifies the timing of plan valuations. Finally, the bill makes several other miscellaneous changes.

— *Tax Relief for Distressed Communities & Industries* —

H.R. 3081 provides approximately $1 billion in tax relief over five years to distressed communities and industries as detailed below. These provisions are similar to the Taxpayer Refund and Relief Act (except that the bill allows the designation of 15, instead of 20, renewal communities).

Community Renewal. The bill authorizes the HUD Secretary to designate 15 "renewal communities" in both urban and rural areas, allowing them to qualify for special tax incentives (at least three must be in rural areas). The bill requires the secretary to adhere to certain eligibility criteria and procedures when designating these communities. These provisions are designed to create jobs, stimulate investment, and assist families in impoverished neighborhoods. In addition to their special designation, renewal communities will receive additional tax incentives over a seven-year period beginning January 1, 2001, and lasting through December 31, 2007. They include:

* **100-percent Capital Gain Exclusion**. H.R. 3081 eliminates capital gains taxes on the sale of any qualified stock, business property, or partnership interest located within renewal communities that have been held for at least five years and that are acquired after December 31, 2000, and January 1, 2008.

* **Family Development Accounts**. The bill establishes family development accounts (FDAs), tax-exempt accounts that allow taxpayers to deduct up to $2,000 for amounts paid in cash to FDAs to benefit "qualified persons"—a person who *both* lives in the renewal community during the tax year and claims the earned income tax credit in the preceding tax year. In addition, other individuals may deduct up to $1,000 annually to benefit a qualified person. FDAs are designed to encourage low-income families to save a portion of their income or their earned income tax credit refund.

  Cash donations are deductible, even if the individual does not itemize, while withdrawals are tax-free if used for a qualified purpose (*i.e.*, post-secondary educational expenses, certain first-home purchase costs, certain business capitalization costs approved by a financial institution or by a nonprofit loan fund, or medical expenses). The measure allows certain qualifying tax-free rollovers of FDA amounts into other accounts to benefit an individual (or a spouse or dependent).

* **Commercial Revitalization Deduction**. H.R. 3081 allows taxpayers to claim a "commercial revitalization deduction" (*i.e.*, an up-front deduction of 50 percent of the cost of renovation or a 100 percent deduction for such costs spread over 10 years) for efforts to build or refurbish commercial-use buildings in renewal communities during a seven-year period between December 31, 2000, and January 1, 2008. Deductions may equal up to $10 million per location. In addition, states may allocate up to $6 million in deductions to each renewal community in the state annually during the seven-year period.

* **Additional Section 179 Expensing**. The measure raises the maximum allowable expensing for purchases of plant and equipment in renewal communities from $25,000 to $35,000. Therefore, businesses in areas with dual-designations may deduct up to $55,000 ($20,000 of additional expensing under current law empowerment zone provisions, and $35,000 in expenses under renewal community provisions). Expense limits may be taken for property valued at up to $200,000, and will be phased out proportionately as the property's value exceeds that amount.

* **Expensing Environmental Remediation Costs ("Brownfields")**. H.R. 3081 permits taxpayers to expense costs incurred in mitigating the impact of environmental contaminants within a designated renewal community. This provision applies to expenditures incurred after December 31, 2000, and before January 1, 2008.

* **Work Opportunity Tax Credit (WOTC)**. The bill provides the WOTC to employers who hire individuals who live and perform most of their work in a renewal community. In addition, should the WOTC expire, businesses located in renewal communities may qualify for a 15-percent tax credit on first year wages (up to $10,000) paid to low-income workers, increasing to 30 percent on second-year wages.

Reforestation Expenditures. Beginning in 2001, the bill increases the cap on expenditures eligible for the reforestation credit from $10,000 to $25,000 per taxable year (from $5,000 to $12,500 for a separate return by a married individual) and eliminates the cap on expenditures eligible for seven-year amortization during 2001-2003.

— *Real Estate* —

H.R. 3081 includes a number of measures to provide approximately $922 million in real estate tax relief over five years. These provisions are detailed below.

Private Activity Tax-Exempt Bonds. H.R. 3081 accelerates the scheduled increase in the limits on tax-exempt private activity bonds to $75 per resident or $225 million if greater (the current limits through 2002 are $50 per resident or $150 million if greater) beginning in 2004 (under current law, the increase will not be effective until 2007). Interest earned on state- and municipally-issued bonds may be excluded from general income if the bond proceeds fund activities conducted and paid for by the localities. Interest on such bonds used to finance activities carried out and paid for by private persons (*i.e.*, "private activity bonds") is taxable unless specifically exempted by the tax code. However, private activity bonds on which interest may be tax-exempt include bonds for (1) privately operated transportation facilities (airports, mass transit, and high speed rail systems); (2) privately owned and/or provided municipal services (water, sewer, solid waste disposal, and electric and heating systems); (3) economic development (to redevelop economically depressed areas); and (4) certain social programs (low-income rental housing, student loan bonds).

Low-Income Housing Tax Credit. The bill phases-in an increase in the $1.25 per capita cap for the low-income housing credit to $1.65 and indexes it to inflation beginning in 2004. It also creates a $2 million minimum per state credit. The credit may be claimed over a 10-year period for the cost of rental housing occupied by tenants that have incomes below certain levels and is available for newly constructed or substantially rehabilitated housing.

Mortgage Obligations. The measure exempts taxpayers from including in gross income any mortgage amount forgiven by a lender if the proceeds of the home sale are insufficient to satisfy the qualified outstanding mortgage. The provision responds to situations where homeowners discover that their outstanding mortgage exceeds the value of their home. Generally, homeowners who are forced to sell their home for less than the amount of the outstanding mortgage must find additional funds to pay off the lender for the mortgage shortfall. In some situations, the lender may forgive the shortfall as an accommodation to the homeowner. However, if the lender forgives the shortfall, current law requires the former homeowner to pay taxes on the amount of the mortgage forgiven by the lender. Current law treats this forgiven debt as if it had been paid to the former homeowner by the lender.

Costs/Committee Action:

The Joint Committee on Taxation estimates that enactment will cost $463 million in FY 2000 (to reinstate the installment method of accounting), $2.4 billion in FY 2001, and a total of $45.8 billion over the FY 2000-2005 period.

The bill was not reported by a House committee.

Other Information:

For information on the Taxpayer Relief and Refund Act, see *Conference Summary*, Vol. XXVIII, CS#106-5, September 10, 1999.

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